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September 20, 2017

VIA eFILING

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17105-3265

Re: Petitions of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company for Approval of a Distribution System Improvement Charge Docket Nos. P-2015-2508942, *et al.*
Office of Consumer Advocate v. Metropolitan Edison Company, *et al.*
Docket Nos. C-2016-2531040, *et al.*

Dear Secretary Chiavetta:

Enclosed please find the **Exceptions** ("Exceptions") **of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company to the Recommended Decision of Administrative Law Judge Joel H. Cheskis issued on August 31, 2017**, in the above-referenced matter.

As evidenced by the enclosed Certificate of Service, copies of the Exceptions have been served upon Administrative Law Judge Cheskis and all parties of record. In addition, as directed in your letter of August 31, 2017, a courtesy copy has been e-mailed to the Commission's Office of Special Assistants.

Please contact me directly if you have any questions or concerns (215.963.5034).

Very truly yours,

Anthony C. DeCusatis

Enclosures

c: Parties of Record (w/encl. as noted above)

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITIONS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY, PENNSYLVANIA POWER COMPANY AND WEST PENN POWER COMPANY FOR APPROVAL OF A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE	:	**Docket Nos. P-2015-2508942, *et al.***
OFFICE OF CONSUMER ADVOCATE	:	**Docket Nos. C-2016-2531040, *et al.***
v.	:	
METROPOLITAN EDISON COMPANY, *ET AL.*	:	

CERTIFICATE OF SERVICE

I hereby certify and affirm that I have this day served a copy of the **Exceptions of Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company to the Recommended Decision of Administrative Law Judge Joel H. Cheskis issued on August 31, 2017** on the following persons in the matter specified in accordance with the requirements of 52 Pa. Code § 1.54:

VIA ELECTRONIC AND FEDERAL EXPRESS

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Dated: September 20, 2017

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PETITIONS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY, PENNSYLVANIA POWER COMPANY AND WEST PENN POWER COMPANY FOR APPROVAL OF A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE	:	**Docket Nos.**	**P-2015-2508942** **P-2015-2508936** **P-2015-2508931** **P-2015-2508948**
OFFICE OF CONSUMER ADVOCATE	:		
v.	:	**Docket Nos.**	**C-2016-2531040** **C-2016-2531060**
METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY PENNSYLVANIA POWER COMPANY WEST PENN POWER COMPANY	:		**C-2016-2531054** **C-2016-2531019**

EXCEPTIONS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY, PENNSYLVANIA POWER COMPANY AND WEST PENN POWER COMPANY

To The Recommended Decision Of
Administrative Law Judge Joel H. Cheskis

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September 20, 2017

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I. OVERVIEW: THE SIGNIFICANCE OF THE CONTESTED ISSUE FOR UTILITY INFRASTRUCTURE INVESTMENT IN PENNSYLVANIA

The decision on the contested issue in this case will determine whether the Distribution System Improvement Charge ("DSIC") can continue to fulfill its legislatively-endorsed purpose of supporting the accelerated replacement and rehabilitation of safety and reliability-related utility infrastructure across the Commonwealth of Pennsylvania. If adopted, the Recommended Decision[1] on the contested issue would severely diminish the effectiveness of the DSIC and jeopardize Pennsylvania utilities' ability to implement the Long-Term Infrastructure Improvement Plans ("LTIIPs") they filed in reliance on the DSIC continuing to be available in the form approved in the Final Implementation Order.[2]

The DSIC has been used by water utilities for twenty years.[3] The success of the DSIC in driving increased investment in vital water infrastructure spurred the legislature – with the support of the Pennsylvania Public Utility Commission ("PUC" or the "Commission") – to extend the DSIC to electric, natural gas, and wastewater utilities by enacting Act 11 of 2012 ("Act 11").

Since the enactment of Act 11, electric, natural gas, water and wastewater utilities have relied on the DSIC as established in the Commission's Final Implementation Order to file LTIIPs. The LTIIPs, once approved by the Commission, committed the utilities that filed them to aggressive schedules for accelerating the replacement and rehabilitation of safety and

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1 Recommended Decision of Administrative Law Judge Joel H. Cheskis issued August 31, 2017 (hereafter, "Recommended Decision" or "R.D."). The Companies do not take exception to the portion of the R.D. recommending approval of the Joint Petition for Settlement of Pending Issues.

2 Final Implementation Order, *Implementation of Act 11 of 2012*, Docket No. M-2012-2293611 (Aug. 2, 2012) ("Final Implementation Order"). *See* Final Implementation Order, pp. 38-39 (affirming that quarterly charges under the DSIC should be determined based on "statutory" federal and state tax rates and without deducting accumulated deferred income taxes from the original cost of "eligible property.")

3 The background and history of the DSIC since it was first adopted for water utilities in 1996 is provided in the Companies' Initial Brief (pp. 11-18).

reliability-related infrastructure. However, all of those utilities will find that their reliance has been misplaced – and that their ability to implement their approved LTIIPs has been seriously jeopardized – if the Office of Consumer Advocate's ("OCA") position on the contested issue is endorsed by the Commission, as the presiding Administrative Law Judge recommends. The Commission should not ignore the significant adverse consequences that would flow from the OCA's erroneous interpretation of Act 40 of 2016 ("Act 40").[4] The Commission should, therefore, grant the Companies' Exceptions and reject the OCA's deeply flawed and legally deficient position for the reasons set forth in detail below and in the Companies' Initial and Reply Briefs filed on September 30 and October 14, 2016, respectively, and in their Supplemental Initial and Supplemental Reply Briefs filed on June 5 and June 21, 2017, respectively.

II. BACKGROUND AND HISTORY OF THIS PROCEEDING

The Companies' Base Rate Cases. On January 19, 2017, the Commission entered its Opinion and Order ("January 19, 2017 Order") in the consolidated base rate cases of Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power") and West Penn Power Company ("West Penn") (individually, a "Company" and, collectively, the "Companies") at Docket Nos. R-2016-2537349, *et al*. The January 19, 2017 Order granted Joint Petitions for Partial Settlements ("Joint Petitions") filed on October 14, 2016, and approved the terms and conditions of the base rate increase settlements set forth therein. The Joint Petitions reserved for briefing and decision

[4] 1 Pa.C.S. § 1921(c)(6): "[T]he intention of the General Assembly may be ascertained by considering, among other matters: . . . (6) The consequences of a particular interpretation." *See also* Section III and Section IV.C., *infra*.

one issue, which pertains to the formula for calculating the DSIC set forth in the Companies' DSIC Riders.

The DSIC Proceeding's Prior Procedural History. The Companies' DSIC Riders were approved by the Commission's Orders entered June 9, 2016 at the above-referenced docket numbers (the "DSIC Orders"). In the DSIC Orders, the Commission referred to the Office of Administrative Law Judge ("OALJ") three DSIC implementation issues that had been raised in pleadings filed by intervenors in this case (e.g., whether the DSIC charge should apply to customers receiving service at "transmission" voltages and whether revenue recovered under certain non-DSIC riders constituted "distribution" revenue). Subsequently, those issues were assigned to Administrative Law Judge Joel H. Cheskis ("ALJ"). A Joint Petition for Settlement of Pending Issues, which encompasses only those issues referred to the OALJ by the Commission's DSIC Orders, was filed on February 2, 2017, together with Statements in Support by the Joint Petitioners. On February 16, 2017, the Joint Petitioners filed and served their joint proposed Findings of Fact, Conclusions of Law and Ordering Paragraphs with respect to the settled issues.

Relationship Of The DSIC Proceeding To The Companies' Base Rate Cases. In its January 19, 2017 Order, the Commission determined it would not decide the issue reserved in the Joint Petitions in the Companies' consolidated base rate cases and, instead, referred the reserved issue to this docket. Additionally, in Ordering Paragraph No. 4 of the January 19, 2017 Order, the Commission transferred to this proceeding "the relevant part of the record" in the Companies' base rate cases including the OCA's Exceptions, the Companies' Replies, the OCA's Main and Reply Briefs, the Companies' Initial and Reply Briefs, OCA Statement No. 1

and the Companies' Statement No. 2-R.[5] The Companies and the OCA each submitted their Proposed Findings of Fact, Conclusions of Law and Proposed Ordering Paragraphs as appendices to their Initial and Main Briefs, respectively.

The Reserved Issue. The issue reserved for decision in the Joint Petitions is whether the enactment of Act 40, which added Section 1301.1 to the Pennsylvania Public Utility Code[6] but does not mention the DSIC, requires the Commission to revise the DSIC formula set forth in the Model Tariff the Commission approved in its Final Implementation Order.[7] (It is not disputed that the Companies' DSIC Riders conform to the terms of the Model Tariff, as the Commission expressly found and determined in the DSIC Orders.[8])

Section 1301.1 precludes the Commission from making consolidated tax adjustments ("CTAs") in determining the federal income tax included in a utility's revenue requirement. It also specifies how the additional income produced by that change should be invested in rate base-eligible property through 2025. Despite the clearly expressed purpose underlying the enactment of Act 40, the OCA's witness, Ralph C. Smith, argued that Section 1301.1 should be interpreted to require the Commission to add a new element to the DSIC formula, namely, a provision that would deduct from the original cost of "eligible property"[9] the incremental federal accumulated deferred income taxes ("ADIT") deemed to accrue from quarterly additions of

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5 On February 3, 2017, the OCA filed a Petition for Reconsideration or Clarification ("Petition") for the limited purpose of requesting the Commission to revise Ordering Paragraph No. 4 to specifically include OCA Statement No. 1-SR. That request was not opposed by the Companies and was granted by the Commission.

6 Hereafter, all references to a "Section" are to sections of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 101 *et seq*., unless otherwise indicated.

7 Final Implementation Order, pp. 30-31 and Appendix A (Model Tariff) to that Order.

8 *See, e.g.,* Met-Ed's June 9, 2016 Order at Docket No. P-2015-2508942 (p. 7) ("Met-Ed's proposed DSIC Rider is consistent with the Model Tariff . . .").

9 *See* Section 1351, which defines "eligible property."

DSIC property.[10] The Companies submitted the rebuttal testimony of Richard A. D'Angelo, FirstEnergy's Manager, Rates and Regulatory Affairs – Pennsylvania, rebutting Mr. Smith's averments,[11] and also addressed the reserved issue in their Initial and Reply Briefs.

Neither Mr. Smith, in his testimony, nor the OCA, in its Main or Reply Briefs, addressed the revisions to the DSIC formula that would be necessary to reflect Pennsylvania state income tax deductions associated with DSIC-eligible property if Mr. Smith's interpretation of Section 1301.1 were to prevail. For that reason, after the reserved issue was referred to this proceeding, the OCA asked to supplement the record to address that additional issue.

With the ALJ's approval, the parties agreed to the procedural schedule set forth in Scheduling Order No. 2 issued on March 6, 2017, whereby the OCA submitted the Supplemental Direct Testimony of Mr. Smith on March 21, 2017; the Companies submitted the Supplemental Rebuttal Testimony of Charles V. Fullem on April 13, 2017;[12] the OCA submitted the Surrebuttal Testimony of Mr. Smith on May 1, 2017; and the Companies' submitted the Rejoinder Testimony of Mr. Fullem on May 5, 2017. The parties waived cross-examination of Messrs. Smith and Fullem, and a telephonic hearing was held on May 12 to admit the supplemental testimony and accompanying exhibits into the evidentiary record. On June 5, 2017, the OCA and the Companies filed their Supplemental Main and Supplemental Initial Briefs, respectively, and, on June 21, 2017, both parties filed their Supplemental Reply Briefs.

The Recommended Decision was issued on August 31, 2017. The R.D. approved the Joint Petition for Settlement of Pending issues. The R.D. also decided the contested issue by

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[10] *See* OCA Statement No. 1, pp. 108-110.

[11] Companies' Statement No. 2-R, pp. 40-43. Mr. D'Angelo explained that Section 1301.1 does not apply to the DSIC and, even if it did, it does not eliminate or diminish the Commission's authority to determine how ADIT and other income tax effects should be recognized in the DSIC rate adjustment mechanism.

[12] Mr. Fullem is the Director, Rates and Regulatory Affairs – Pennsylvania, for FirstEnergy Service Company.

adopting the OCA's position on burden of proof, the OCA's proposed interpretation of Act 40, and the OCA's proposed changes to the DSIC formula to introduce new terms needed to reflect state income taxes deductions in the manner the OCA believes Section 1301.1 requires.

The Companies do not take exception to the R.D.'s recommendation that the Commission approve the Joint Petition for Settlement of Pending Issues. The Companies do, however, take exception to the ALJ's recommendations pertaining to the contested issue.

III. EXCEPTIONS

The Companies respectfully note the following Exceptions to the Recommended Decision:

1. The Companies Do Not Bear The Burden of Proof. Exception is taken to the recommendation (R.D. pp. 14-16) that the Companies bear the burden of proof to establish that the terms of their Commission-approved DSIC Riders are in conformity with the law and are "just and reasonable." As the Commission found and determined in the DSIC Order, the Companies' DSIC Riders conform to the Model Tariff and implement the DSIC formula that was expressly approved by the Commission in the Final Implementation Order pursuant to the mandate of Sections 1353(b)(1) and 1358(d).[13] While the immediate object of the OCA's dispute is allegedly the Companies' DSIC Riders, the OCA is, in reality, seeking to collaterally attack the Final Implementation Order and the Model Tariff. As such, the OCA's proposal to revise the terms of the Commission-approved DSIC formula challenges an existing, approved rate and, therefore, the OCA has the burden of proof.[14]

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[13] Section 1358(d) requires that the Commission "by regulation or order . . . prescribe the specific procedures to be followed to approve a distribution system improvement charge." Section 1353(b) (1) requires the Commission to adopt a "model tariff" as the means of implementing the command of Section 1358(d) and requires any utility seeking to establish a DSIC to file "an initial tariff" that conforms to the model tariff.

[14] Companies' Supplemental Reply Brief, pp. 5-4. *See also* Companies' Initial Brief, pp. 27-31.

2. Act 40 Did Not Nullify The Commonwealth Court's Decision In *McCloskey v. Pa. P.U.C.* And, Under The Fundamental Principles Established In That Case, The DSIC In Its Current Form Fully And Properly Accounts For Both ADIT And State Income Tax Deductions Associated With "Eligible Property." Exception is taken to the recommendation (R.D. pp. 22-27) that the Commission find that Act 40 nullified *McCloskey* and retroactively invalidated the fundamental principles established in that case. In *McCloskey*, the Commonwealth Court affirmed the Commission's findings and conclusions that: (1) the entire Model Tariff, including all of its terms and conditions, constitutes the "rate" that must be analyzed for conformity with the law and established ratemaking principles; (2) the "earnings cap" provisions of the DSIC rate require the equivalent of a non-general base rate case analysis to be performed (and filed with the Commission) each quarter; (3) the earnings cap analysis takes into account a DSIC-using utility's *entire* revenue requirement, including ADIT and state tax deductions related to *all* of its property, *including* quarterly additions of "eligible property"; (4) based on the earnings cap analysis, the utility's DSIC rate must be "reduced" (i.e., taken all the way to zero), if a utility is shown to be exceeding its allowed rate of return on equity. None of these basic principles were affected by the enactment of Act 40. And, these principles compel the conclusion that, even if Act 40 applied to the DSIC, the terms of the DSIC fully and properly take into account, in the rate-setting process, ADIT and state income tax deductions related to "eligible property."

3. Act 40 Was Intended And Designed To Apply Only To Base Rates And Does Not Apply To Section 1307 Adjustment Clauses Such As The DSIC. Exception is taken to the recommendation (R.D., pp. 27-29) that the Commission ignore the clear legislative directives present in the legislative record of H.B. 1436 (which became Act 40) that Section

1301.1 should apply only to "base rates."[15] The OCA argued that Section 1921(c) of the Statutory Construction Act[16] prohibits the Commission from considering factors such as the stated purpose, circumstances of enactment and contemporaneous legislative history of Act 40 because the Act's language is "explicit" and "clear and unambiguous." The R.D. accepted that argument at face value without addressing – or discussing – the evidence and analysis to the contrary that the Companies presented in the record and in their Initial and Reply Briefs.[17] Act 40 employs language that simply does not make sense except in the context of base rate cases. And, as a consequence, textual evidence from within the four corners of Act 40 shows that, with respect to the key issue in this case, the Act is "not explicit" and, therefore, there is a sound legal basis for consulting the factors listed in Section 1921(c) of the Statutory Construction Act. The OCA's attempt to divert attention from the Section 1921(c) factors for discerning legislative intent is a thinly-concealed concession that if the purpose, goals, circumstances of enactment and legislative history of Act 40 were consulted, the inescapable conclusion is that Act 40 does not apply to the DSIC.

4. The Effective Date Provision Of Act 40 Underscores Why The Language Of Act 40 Is "Not Explicit." Moreover, Attempting To Apply Act 40 To The DSIC Requires Finding That The Final Implementation Order Is The "Final Order" That Established The Effective Date Of Act 40. Because That Order Was Entered In August 2012, Act 40 Should Not Apply To The DSIC. Exception is taken to the recommendation (R.D. pp. 28-29) that the Commission find that the "final order" establishing the DSIC was entered after the effective date

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[15] Key participants in the legislative process expressly stated that "this section applies to base rate cases," "would only go into effect when a utility comes in for a base rate case," and sets forth requirements for calculating federal income taxes "when establishing base rates for a regulated utility." *See* Section III, C., *infra*.

[16] 1 Pa.C.S. § 1921(c).

[17] Companies' Initial Brief, pp. 22-28, and Companies' Reply Brief, pp. 4-5, 7-11. *See also* Companies' Supplemental Initial Brief, pp. 5-7 and Supplemental Reply Brief, pp. 12-15.

of Act 40. As a preliminary matter, the difficulty in determining what is a "final order" in the context of the DSIC is further evidence of the lack of clarity in the language of Act 40. That lack of clarity fully justifies considering the legislative record, which establishes that Act 40 applies only to base rates. However, even if one assumed Act 40 could apply to the DSIC, the Final Implementation Order, which implemented the mandates of Sections 1358(d) and 1353(b) by establishing the Model Tariff every utility proposing a DSIC must adopt, is the "final order" that must be used to demarcate the application of Act 40.[18] Since the terms of the DSIC were established long before Act 40 became effective, Section 1301.1 does not apply to the DSIC.

5. The OCA's Proposals To Implement Its Interpretation Of Act 40 Conflict With The Terms Of Sections 1351 And 1357(b). Moreover, There Is No Practical Way To Apply The OCA's Proposals To The DSIC, And All Of The OCA's Proposed Implementation Methods Would Add Excessive And Needless Complexity To The Calculation, Administration And Auditing Of DSIC Costs And Revenues. Exception is taken to the recommendation (R.D., pp. 29-33) that the Commission find there is a practical method for implementing the OCA's proposed interpretation of Act 40 that does not conflict with the express terms of Subchapter B of Chapter 13 of the Public Utility Code and does not introduce excessive and needless complexity to the calculation, administration and auditing of the DSIC. Significantly, neither Section 1351, which defines "eligible property," nor Section 1357, which provides detailed instructions as to how quarterly DSIC charges are to be calculated, includes any terms that would include ADIT or state income tax deductions associated with "eligible property." The absence of such terms evidences a clear legislative intent that neither ADIT nor property-related state income tax deductions must be reflected in calculating quarterly

[18] *See* Section 1301.1(c)(2).

DSIC charges. It also created significant problems for Mr. Smith and the OCA in attempting to implement their interpretation of Act 40. As explained in detail in the Companies' supplemental testimony[19] and Supplemental Initial Brief (pp. 9-18), there is no practical way to implement the changes to the DSIC calculation that Mr. Smith and the OCA propose. In fact, attempting to calculate an "effective" state income tax rate (as Mr. Smith recommends) for use in developing the revenue conversion factor to "gross-up" the return to the "pre-tax" level would entangle the Commission (and the Bureau of Audits, in its pre-implementation review of quarterly DSIC charges and when it attempts to audit the DSIC) in a detailed revenue requirement computation replicating the kind of full base rate case analysis that the Commission has repeatedly stated it wanted to avoid in establishing the terms of the DSIC.[20] The Commission, in designing the Model Tariff, rejected the kind of complexity the OCA now wants to interject.

IV. ARGUMENT

A. The Companies Do Not Have The Burden Of Proving The Justness And Reasonableness Of DSIC Riders That The Commission Has Already Held Conform To The Model Tariff And The Final Implementation Order

The R.D. accepts the OCA's argument that the Companies bear the burden of proof to establish the justness and reasonableness of their DSIC Riders.[21] The OCA's contention was, however, based on its assumption that the DSIC is a "proposed rate."[22] Thus, the OCA confused a monetary charge with the entire DSIC adjustment mechanism and implicitly assumed that the

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[19] Companies' Statement No. 1-R (Supp.) and Companies' Statement No. 1-RJ.

[20] Final Implementation Order, p. 39; *McCloskey*, 127 A.3d at 870-871. *See* Companies' Supplemental Initial Brief, pp. 18-20, and Companies' Supplemental Reply Brief, pp. 4 and 19.

[21] The R.D. (pp. 15-16) recommends that the OCA bear the burden of proof to show that the *methods* it proposes to *implement* its interpretation of Act 40 are lawful and reasonable. The Companies do not take exception to this recommendation.

[22] *See e.g.,* OCA Supp. Main Brief, p. 5 ("Thus, a utility has an affirmative burden to establish the justness and reasonableness of every component of its *rate request*" (emphasis added).)

former is at issue but the latter is not. Of course, that position contravenes the OCA's own position in this case, which seeks a change in the fundamental terms of the DSIC Riders and, by necessary extension, in the Commission-approved Model Tariff and Final Implementation Order as well.

As previously noted in Section III (Exception 2), *supra*, and as discussed in more detail in Section IV.B., *infra*, the "rate" for each Company is its entire DSIC Rider, and those Riders are no longer "proposed." The Riders are currently in effect pursuant to the DSIC Orders, which found and determined that they conform to the Model Tariff.[23] Indeed, for that reason, the real object of the OCA's proposal in this case is not the Companies' DSIC Riders, but the Model Tariff and the Final Implementation Order approving it. The Commission's findings and conclusions in all of those Orders are "prima facie evidence of the facts found and shall remain conclusive upon all parties affected thereby."[24] The OCA is the party collaterally attacking and seeking to overturn the relevant portions of the Final Implementation Order, the Model Tariff, and the DSIC Orders that determined the Companies' DSIC Riders conform to the Model Tariff. Accordingly, as to all issues, the OCA is the party with the "burden of proof."

B. The DSIC In Its Current Form Fully And Properly Accounts For Federal Deferred Income Taxes And State Income Tax Deductions Associated With "Eligible Property".

Act 11 added an entire Subchapter to Chapter 13 of the Public Utility Code[25] setting forth comprehensive, detailed provisions for establishing, calculating and administering the DSIC as

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[23] Although the DSIC Orders assigned certain issues to the OALJ, none of those issues pertained to the fundamental terms of the Model Tariff or the fundamental terms of the DSIC approved in the Final Implementation Order. In fact, the scope of the assignment was strictly limited to the specific issues delineated in Ordering Paragraph No. 4 of each of the DSIC Orders. The specifically assigned issues are the subject of the Joint Petition for Settlement of Pending Issues that was filed on February 2, 2017.

[24] Section 316, 66 Pa.C.S. § 316.

[25] Chapter 13, Subchapter B, Sections 1350-1360, 66 Pa.C.S. §§ 1350-1360.

the means of supporting accelerated infrastructure investment. Shortly after Act 11 became effective, the Commission issued a policy statement and then formal regulations specifying the contents of an LTIIP, which Act 11 requires a utility to adopt as a condition precedent to implementing a DSIC. And, pursuant to Section 1353(b)(1), the Commission entered the Final Implementation Order, which established a Model DSIC Tariff that all utilities desiring to implement a DSIC were required to adopt. In compliance with those Commission decisions, every major DSIC-qualified utility in Pennsylvania submitted an LTIIP committing it to a multi-year schedule for substantially accelerating its investment in safety and reliability-related infrastructure.

Notwithstanding this extensive backdrop of prior legislation and administrative decisions, the OCA contends that Act 40 (which never mentions the DSIC and was passed for a limited purpose unrelated to the DSIC)[26]: (1) fundamentally changed specific, carefully-crafted, and inter-related provisions of the DSIC legislation;[27] (2) invalidated the extensive work the Commission has done to implement the DSIC legislation; and (3) legislatively overruled the Commonwealth Court's opinion and order in *McCloskey v. Pa. P.U.C.*[28]

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[26] Even the Acting Consumer Advocate, in testimony before the House Consumer Affairs Committee, stated that the purpose of H.B. 1436 – the bill that became Act 40 – was to "eliminate the longstanding consolidated tax savings adjustment." H.B. 1436 Public Hearing, Tr. 31.

[27] As more fully explained hereafter, the OCA's interpretation of Act 40 is completely at odds with the explicit language of Section 1351 defining "eligible property" and would unlawfully read into Section 1357(b)(1) the word "effective" before "State income tax rates." In short, critical statutory provisions in Subchapter B of Chapter 13 would have to be substantively re-written to accommodate the OCA's approach.

[28] 127 A.3d 860 (Pa. Cmwlth. 2015) ("*McCloskey*"). This case was an appeal by the OCA from a Commission Order approving a DSIC for Columbia Gas of Pennsylvania, Inc. ("Columbia"). Similar issues were also decided in an unreported opinion and order issued the same day in the OCA's appeal from a Commission Order approving a DSIC for Little Washington Wastewater Company ("Little Washington"). *McCloskey v. Pa. P.U.C.*, No. 1358 C.D. 2014 (Nov. 3, 2015) ("*McCloskey-Little Washington*").

McCloskey v. Pa. P.U.C. affirmed the Commission's determination[29] that the DSIC mechanism, viewed in its entirety – as it must be – properly accounts for federal ADIT and Pennsylvania state income tax deductions associated with "eligible property" in setting rates. Simply stated, the Court agreed that the Commission did not ignore those tax effects in the rate-setting process as the OCA erroneously asserted.

The OCA contends that *McCloskey* has been invalidated by the enactment of Act 40. The Recommended Decision accepted that conclusion at face value without addressing the arguments against it, which were set forth at length in the Initial (pp. 9-10, 14-15 and 32-39) and Reply (pp. 5-6, 12-15) Briefs filed by the Companies. Contrary to the OCA's contentions, *McCloskey* and the Columbia Order it affirmed established fundamental principles that were unaffected by Act 40 and require the Commission to reject the OCA's position even if Act 40 – contrary to its express purpose and the legislature's clear intent – were applied to the DSIC.[30]

First, *McCloskey* and the Columbia Order establish that the "rate" to be scrutinized for conformity with the law and applicable ratemaking principles is the *entire* DSIC mechanism embodied in the Model Tariff (and adopted as a utility's DSIC Rider upon Commission approval). The "rate" is *not* simply the quarterly charge that the DSIC formula produces; it is the entire DSIC Rider. Thus, in the Columbia case, the Commission based its decision on the Administrative Law Judge's determination (which, in turn, was based on blackletter law) that:

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[29] *Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution Sys. Improvement Charge*, Docket No. P-2012-2338282 (Final Order entered May 22, 2014) ("Columbia Order").

[30] As explained in the Companies' Initial (pp. 22-27) and Reply (pp. 4-5 and 9-11) Briefs, there is clear textual evidence *within the four corners of Act 40* signaling the legislature's intent that Section 1301.1 apply only to base rates. Even if that internal textual evidence were deemed inconclusive, it provides a sound legal basis under Section 1921(c) of the Statutory Construction Act, 1 Pa.C.S. § 1921(c), to consider the eight factors listed therein, which express the legislature's intent that Act 40 apply only to "base rates." *See* Companies' Initial Brief, pp. 8-9, 25-26 and Appendices A and B.

"[I]n Pennsylvania a rate is defined as more than just the individual components of the mechanism, but rather the entire mechanism and all rules and regulations associated with it."[31]

Second, the DSIC "rate" expressly accounts for all ADIT and state income tax effects of a utility's property, including those associated with quarterly additions of "eligible property." Specifically, the DSIC mechanism requires a utility to submit *each quarter*, along with the quarterly update of its DSIC charge, a calculation of its actual, achieved rate of return on equity based on the *totality* of the components comprising the utility's revenue requirement, i.e., rate base, taxes, depreciation, and operating and maintenance expenses. This calculation reflects the *cumulative* ADIT and state tax effects related to all of a utility's property, including each quarterly addition of "eligible property." The product of the calculation is used directly in setting the utility's "rates" because, if the utility's achieved equity return exceeds the equity return allowed for DSIC purposes (the "earnings cap"), the utility must reduce its DSIC charge to *zero*. Act 40 did not in any way alter this important element of the DSIC.

Third, in *McCloskey*, the Court found and determined that the quarterly earnings cap calculation mandated by the DSIC mechanism conforms to the rate-setting process the Commission employs, with the Court's prior affirmance, in non-general base rate cases.[32] Thus, the DSIC "rate" requires DSIC-using utilities to submit the equivalent of a non-general base rate case analysis each quarter to determine whether they can charge the DSIC at all. Those quarterly

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[31] *Petition of Columbia Gas of Pennsylvania, Inc. for Approval of a Distribution Sys. Improvement Charge*, Docket No. P-2012-2338282 (R.D. issued Mar. 6, 2014), p. 45 ("Columbia R.D."). In the Columbia Order (p. 58), the Commission adopted the R.D. in relevant part. The R.D. is an accurate statement of Pennsylvania law as set forth in Section 102, which defines a "rate" as including "rules, regulations, practices . . . affecting any charge." *See also* Companies' Initial Brief, pp. 27-30, citing additional authority from the Federal Energy Regulatory Commission, the United States Court of Appeals for the D.C. Circuit and appellate court precedent from a jurisdiction where the statutory definition of a public utility "rate" is virtually identical to the definition in Section 102.

[32] *Popowsky v. Pa. P.U.C.*, 683 A.2d 958 (Pa. Cmwlth. 1996) (approving the Commission's methodology for analyzing and approving a non-general base rate case for Equitable Gas Company); *McCloskey, supra*, pp. 868-869. *See* Companies' Initial Brief, pp. 35-39).

non-general base rate case analyses, far from ignoring the impact of ADIT and state income tax deductions associated with "eligible property," take into account all of the utility's ADIT and property-related state income tax effects, including those generated by quarterly additions of DSIC-eligible property.

In short, even if Act 40 applied to the DSIC, the DSIC includes ADIT and property-related state income tax effects as an integral component of the rate-setting process conducted each quarter to determine whether the DSIC may be charged or whether it must be "reduced" to zero. Thus, the approach historically used by the Commission and approved in *McCloskey* to calculate DSIC charges conforms to the requirements of Section 1301.1(a). The OCA's approach, on the other hand, asks the Commission to ignore the totality of a DSIC-using utility's revenue requirement and focus narrowly on the incremental effects of each quarterly addition of "eligible property." Nothing in Section 1301.1(a) justifies – let alone requires – such micromanaging of the DSIC rate-setting process.

C. Act 40 Does Not Apply To The DSIC

As explained above, the DSIC, as implemented by the Final Implementation Order, would comply fully with the terms of Act 40, if Act 40 applied. However, Act 40 does *not* apply to the DSIC; it applies only to base rates.

Act 40 added Section 1301.1 to the Public Utility Code to eliminate the use of CTAs in calculating utility base rates.[33] And, because CTAs are reflected *only* in base rate calculations – not in the calculation of charges under any Section 1307 adjustment mechanisms – there is strong contemporaneous evidence that Act 40 was designed, and intended, to apply only to base

[33] *See* Public Hearing In Re: House Bill 1436, Pennsylvania House of Representatives, Consumer Affairs Committee, Sept. 29, 2015 ("H.B. 1436 Public Hearing"), Tr. at 4-5 (Opening Statement of Chairman Robert Godshall): "House Bill 1436 would eliminate the consolidated tax approach and adopt a standalone approach used by a majority of the states and the Federal Energy Regulatory Commission."

rates. Indeed, two important participants in the legislative process, Representative Robert Godshall, the Chairman of the House Consumer Affairs Committee and lead sponsor of H.B. 1436, and the Honorable Gladys M. Brown, Chairman of the Commission, who submitted testimony to the Committee, stated that Act 40 would apply only to "base rates."

Representative Godshall, in remarks on the House floor, explained the scope and application of Section 1301.1 by stating that "this section applies to *base rate cases*" and "would only go into effect when a utility comes in for *a base rate case*."[34] Chairman Brown stated in relevant part: "The proposed bill introduces legislation that requires a public utility's federal income tax expense to be calculated on a 'stand-alone' basis . . . *when establishing base rates* for the regulated public utility . . ."[35]

The OCA did not dispute the Companies' accurate description of the purpose, goals, circumstances of enactment and legislative intent underlying Section 1301.1. Indeed, those elements are set forth in official legislative documents, and their meaning is clear. For its part, the Recommended Decision likewise did not take issue with the evidence of legislative intent the Companies submitted. Rather, both contend that the legislative record must be ignored in its entirety because Section 1921(c) of the Statutory Construction Act allegedly does not allow the Commission to give any consideration to Act 40's purpose, goals, circumstances of enactment and legislative history. In so doing, they illuminate an important, but unstated, assumption: if the factors previously enumerated are consulted, the clarity of the legislative record compels the

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[34] House of Representatives Legislative Journal, Feb. 8, 2016, p. 117 (emphasis added). (The first quote is from a longer passage that, as transcribed in the Legislative Journal, reads "this section applies to base rate cases where the PUC finally orders an issue after the effective date." From the context it is clear that there was a transcription error that transposed "issues" and "order," and the passage should read "finally issues an order after the effective date.").

[35] Prepared Testimony of Gladys M. Brown, Chairman, Pennsylvania Public Utility Commission, p. 4 (see Companies' Initial Brief, Appendix D).

conclusion the Companies have articulated – Act 40 applies only to the calculation of "base rates."

Both the OCA and the R.D. get it wrong. With respect to the issue that is central to this case – whether Act 40 applies only to base rates – the words of Section 1301.1 are demonstrably "not explicit" in several critical respects.[36] In short, textual evidence *within the four corners of Act 40* satisfies the prerequisite for considering the factors Section 1921(c) lists for discerning legislative intent. This is most evident in Act 40's use of the terms "rate base" and "final order."

"Rate Base." The term "rate base" does not appear in any of the DSIC-related sections added to the Public Utility Code by Act 11. This is not a coincidence. The DSIC is designed to reflect only a subset (i.e. "fixed costs" of "eligible property") of the elements that, in a base rate case, would be included in "rate base." The concept of "rate base" is, however, highly relevant in proceedings to establish base rates, where all of the other elements that comprise a utility's "rate base," including, for example, cash working capital, prepaid expenses, materials and supplies, unamortized investment tax credits, customer advances, contributions in aid of construction and customer deposits, are identified, quantified and added, or deducted, as

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[36] Section 1921(c) of the Statutory Construction Act provides as follows:

> (c) When the words of the statute are not explicit, the intention of the General Assembly may be ascertained by considering, among other matters:
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> (1) The occasion and necessity for the statute.
>
> (2) The circumstances under which it was enacted.
>
> (3) The mischief to be remedied.
>
> (4) The object to be attained.
>
> (5) The former law, if any, including other statutes upon the same or similar subjects.
>
> (6) The consequences of a particular interpretation.
>
> (7) The contemporaneous legislative history.
>
> (8) Legislative and administrative interpretations of such statute.

appropriate, to determine a utility's investment on which it may earn a return. Consequently, Act 40's specific reference to "deferred income taxes *used to determine the rate base of a public utility for ratemaking purposes*" (emphasis added) is relevant only in the context of a base rate proceeding.

"Final Order." Act 40 provides: "This section shall apply to all cases where the final order is entered after the effective date of this section." The term "final order" does not appear in any DSIC-related Code sections, nor does it appear in Section 1307. The term "final order" is, however, readily discerned in the context of a general base rate case because Section 1308(d) requires the Commission to enter a "final decision and order" prior to the end of the statutory suspension period:

> Before the expiration of such seven-month period, a majority of the members of the commission serving in accordance with law, acting unanimously, shall make a final decision and order, setting forth reasons therefor, granting or denying, in whole or in part, the general rate increase requested.

Because a "final order" is so inextricably associated with base rate cases, and so easily identified in that context, the legislature's use of the term "final order" in Act 40 also supports the conclusion that its legislative history impels – Act 40 only applies only to "base rates." Indeed, Representative Godshall's remarks in the legislative record speak plainly to this point: "[T]his section applies to base rate cases where the PUC finally [issues] an [order] after the effective date."[37] However, at a minimum, it adds substantial evidence that, on the issue central in this case, the words of Act 40 are "not explicit" and, therefore, the factors enumerated in Sections 1921(c)(1)-(8) should be considered.

[37] House of Representatives Legislative Journal, Feb. 8, 2016, p. 117.

In order to support its interpretation of Act 40 in the face of strong contrary evidence from the legislative record, the OCA argued that Act 40 was "explicit" and "clear and unambiguous." However, even the OCA backed off from its hard line when the time came to explain how its interpretation of Act 40 might be implemented (i.e., how the DSIC formula and quarterly update computations would have to change to accommodate the OCA's position). The OCA recognized that its interpretation of Section 1301.1 conflicts with Section 1357, which provides detailed specifications for calculating DSIC charges. As a result, the OCA eventually conceded that the rules of statutory construction had to be consulted to try to untangle the ambiguities its interpretation necessarily created.[38] The existence of ambiguities in Section 1301.1 that may justify the OCA's resort to the rules of statutory construction to *implement* its interpretation of Act 40 cannot be affirmed while, simultaneously, the ambiguities facially apparent in Act 40 itself are rejected as a valid reason to consult the factors listed in Sections 1921(c)(1)-(8) of the Statutory Construction Act to assess the reasonableness of the OCA's interpretation itself.[39]

D. Under The Effective Date Provision Of Act 40, Section 1301.1 Does Not Apply To The DSIC Riders

As explained above, the difficulty in discerning what the "final order" might be in the context of the DSIC amplifies the lack of clarity in the words of Act 40. Even if, for purposes of argument, one assumed Act 40 applies to more than just base rates, where would one look to find the "final order" that demarcates the effective date of Act 40 to the DSIC? As explained in the Companies' Initial (pp. 27-31) and Reply (pp. 5 and 12) Briefs, in this context, the Final Implementation Order is the only order it would make any sense to consider a "final order"

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[38] OCA Supplemental Initial Brief, p. 14.

[39] *See* Companies' Supplemental Reply Brief, pp. 17-18, where this point is addressed in detail.

because it established the Model Tariff and, as required by Section 1353(b)(1), it mandated that all utilities seeking to establish a DSIC must adopt the terms of the Model Tariff. Since the Final Implementation Order was entered on August 2, 2012, its terms would be unaffected by Act 40.[40]

E. The OCA's Proposals To Implement Its Interpretation Of Act 40 Conflict With The Terms Of Sections 1351 and 1357(b), Are Impractical To Apply, And Would Add Excessive And Needless Complexity To The Calculation, Administration And Auditing Of DSIC Charges

As explained in the Companies' Supplemental Initial (pp. 9-13) and Supplemental Reply (pp. 16-17) Briefs, the OCA confronted a serious problem when the time came to explain how its interpretation of Act 40 might actually be implemented in a manner that does not violate the specific, detailed instructions for designing the DSIC and calculating DSIC charges that the legislature incorporated in the DSIC-related sections of the Public Utility Code. The irreconcilable conflicts between two parts of Chapter 13 that the OCA's interpretation would introduce add even more weight to the already substantial body of evidence showing that Act 40 should only apply to base rates, not the DSIC. At a minimum, the conflicts created by trying to apply Act 40 to the DSIC unquestionably justify a careful examination of the factors set forth in Sections 1921(c)(1)-(8) of the Statutory Construction Act to discern the legislature's intent in enacting Act 40. When those factors are given the serious consideration they warrant, there ceases to be any appearance of conflicting statutory language because the intent of the legislature to apply Act 40 only to base rates is clear and unmistakable.

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[40] Notably, the R.D. presupposes that the "final order" for a DSIC is the order the Commission enters allowing a utility to establish a DSIC. For the Companies, those orders, which found that the Companies' DSIC Riders conformed to the Model Tariff, were entered on June 9, 2016 – also prior to Act 40's effective date. However, since a utility proposing a DSIC *must* adopt the Model Tariff, and the Commission, to allow a DSIC to be implemented, *must find* that the utility's proposed tariff conforms to the Model Tariff, the only order that has real substantive effect in this context is the Final Implementation Order.

The OCA's position on the application of Act 40 to the DSIC impacts two fundamental elements of the DSIC formula, namely, "eligible property" and "pretax return," which are denoted "DSI" and "PTRR," respectively, in the Commission-approved DSIC formula. Both of these DSIC elements are identified and defined by statute. The ADIT and state tax effects the OCA advocates interjecting into the quarterly DSIC calculation implicate both provisions.

1. ADIT

In base rate cases, where all the elements comprising a utility's rate base are examined and adjudicated, ADIT is a separate line item reflected as a deduction from rate base. The OCA proposes that a single line-item in the rate base calculation – namely, ADIT – be incorporated into the calculation of quarterly DSIC charges. However, because "rate base" is not an element in the calculation of quarterly DSIC charges, the analogy to the calculation of rate base in a base rate case does not fit the DSIC formula defined in Subchapter B of Chapter 13 and the Final Implementation Order. Consequently, the OCA has an obvious problem in trying to implement this aspect of its proposal.

The OCA tried to resolve this implementation issue by contending that ADIT should be treated as a deduction in deriving the value of "eligible property." This proposal, however, conflicts with two specific terms of the DSIC-related sections of the Public Utility Code. First, the definition of "eligible property" in Section 1351 does not authorize a separate line-item deduction for ADIT such as the OCA proposes. Second, Section 1357, which delineates how quarterly DSIC charges are to be calculated, does not include any term in the DSIC formula that would reflect ADIT. Sections 1357(a)(1) and (3) provide that the "[DSIC] charge shall be calculated to recover the fixed cost of eligible property," which, "shall consist of depreciation and pretax return." "Eligible property" is to be included in the calculation of quarterly DSIC

charges at its "original cost,"[41] and there is no provision in Section 1357 for deducting ADIT or any other amounts from "original cost."[42] The elements of the DSIC formula are precise and do not authorize the kind of deduction the OCA is trying to force-fit into the DSIC calculation.

ADIT also does not fit into the definition of "pretax return." Even if ADIT were viewed as an additional source of capital that the federal government provides, for a limited time, at no cost to a utility, there is no element of the calculation prescribed in Sections 1357(b)(1) and (2) that reflects any additional source of capital – apart from "long-term debt and preferred stock" and "equity" – in computing "pretax return." Here again, ADIT does not fit the statutorily prescribed DSIC formula, which the Commission adopted in the Final Implementation Order.

2. Property-Related State Income Tax Deductions

The OCA faced an even more difficult problem trying to implement its position regarding property-related state income tax deductions because neither of the two approaches its witness proposed fit the statutory terms for calculating the DSIC and both methods would add enormous complexity to calculating, administering and auditing the DSIC.

The OCA's first method for injecting property-related state tax deductions into the DSIC calculation would necessitate two significant changes to the DSIC formula set forth in Section 1357 and approved in the Final Implementation Order. Initially, the tax component would have to be stripped from the calculation of "pretax" return. Then, an entirely new factor would have to be added to the DSIC formula to provide for a free-standing calculation of income taxes. In effect, a calculation of state income taxes related to the return component comparable to that

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41 Section 1357(b).

42 Similarly, there is no provision for any *additions* to original cost such as those reflected in calculating "rate base" in base rate cases. One significant example in this regard is the reduction in a utility's total ADIT balance, which may occur over time as the deferred taxes represented by the ADIT balance "reverse" each year (i.e., "deferred" taxes become "current" taxes paid to the federal government because accelerated forms of tax depreciation eventually fall below the level of book depreciation used to measure the "deferral.").

done in base rate cases would have to be carried over to the calculation of quarterly DSIC charges. And, because the level of state income taxes is a deduction in computing federal income taxes, the calculation of federal income taxes would also have to be revised. Not surprisingly, the OCA's witness, while describing this convoluted and statutorily unauthorized method, quickly backed away from it in favor of his "preferred" method.

The OCA's preferred method is hardly less complicated than the free-standing calculation of state income taxes described above. For this method, OCA witness Smith recommended changing the way the pre-tax weighted average rate of return on equity (a component of "PTRR" in the DSIC formula) is calculated.[43] Specifically, he recommended that the revenue conversion factor used to "gross up" the allowed equity return to a pre-tax level reflect the "actual amount of state income taxes that will be paid on DSIC income."[44] In his Supplemental Direct Testimony, Mr. Smith described his proposed revision on a conceptual basis, but did not identify any specific changes to the DSIC formula. Mr. Smith also did not provide a calculation using the Companies' own data (previously supplied in their DSIC filings) to show how his concept might be implemented consistent with the Commission's directive that a rate adjustment clause should not require a full base-rate revenue requirement computation.

Faced with Mr. Smith's lack of specificity, the Companies' witness, Mr. Fullem, addressed the possibility (which Mr. Smith finally affirmed in his Supplemental Surrebuttal Testimony) that Mr. Smith intended the revenue conversion factor to reflect an "effective" state

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[43] *See* OCA St. 1-Supp, p. 2.

[44] *Id*.

income tax rate to gross-up the return component of the DSIC formula.[45] Mr. Fullem also explained the defects inherent in the "effective tax rate" approach:[46]

> If, however, Mr. Smith intends that the revenue conversion factor applied to the weighted average equity cost rate should reflect an "effective" state tax rate on DSIC income, then his recommendation is contrary to both the Commission's Model Tariff, which specifies that "statutory" tax rates must be used, and Section 1357(b)(1), which does not mention the use of an "effective" tax rate but, instead, states that "the pre-tax return shall be calculated using the Federal and State income tax rates."

An "effective" tax rate, as typically understood, can differ from the "statutory" tax rate because the effective tax rate is typically derived by dividing the actual income taxes paid (in this instance, state income taxes) by net income before income taxes as determined for financial reporting purposes.[47] The effective tax rate, thus defined, would differ from the statutory state tax rate if the taxable income calculated for state income tax purposes is different from pre-tax net income calculated for financial reporting purposes. This would be the case where, for example, depreciation for financial reporting (and regulatory purposes) differs from the depreciation deductions taken, pursuant to state law, for state income tax purposes.[48] Thus, Mr. Smith's approach would require a three-step process: first, deductions attributable to adding DSIC-eligible property (principally, accelerated forms of depreciation) would have to determined and calculated; second, book depreciation, which is reflected (and already deducted for tax purposes) under the Model Tariff's DSIC formula, must be subtracted from the projected tax depreciation; and third, the resulting net deduction would have to be converted from a dollar amount to a revenue conversion factor stated as a percentage and applied to the after-tax

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45 *Id*.

46 *Id*.

47 Companies' St. 1-R (Supp), p. 8.

48 *Id*.

weighted average return rate to "gross-up" that rate to a pre-tax level.[49] Obviously, that process is very far from the "straightforward mechanism" the Commission has always envisioned the DSIC to be. As Mr. Fullem explained, "there is not a practical way to implement Mr. Smith's recommendation, and attempts to do so would embroil the Commission in the kind of comprehensive revenue requirement analysis it has previously held is not required for calculating the [quarterly] DSIC."[50]

In his Supplemental Surrebuttal Testimony, Mr. Smith attempted to redress his earlier failure to show how his recommendation could be implemented by offering an illustrative calculation.[51] However, Mr. Smith's example raised more problems than it resolved, as Mr. Fullem explained in pointing out the defects in Mr. Smith's approach. First, Mr. Smith's calculations clearly show he is advocating the use of an "effective" tax rate, for which there is no authority in Section 1357:

> Although Mr. Smith shows the "statutory" state income tax rate of 9.99% being used in the table on page 4, he applies it to "taxable income" that reflects an assumed level of state income tax deductions. Consequently, what Mr. Smith proposes results, nonetheless, in the use of an "effective" state income tax rate, not the "statutory" tax rate in the DSIC formula.[52]

Second, Mr. Smith's method double counts book depreciation in calculating the "effective" state tax rate, as Mr. Fullem demonstrated[53] and as explained in detail in the Companies' Supplemental Initial Brief (pp. 16-17).

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[49] *See* Companies' St. 1-R (Supp), p. 10; Companies' St. 1-RJ, pp. 4-5.

[50] Companies' St. 1-R (Supp), p. 10 and n. 5.

[51] *See* OCA St. 1SR-Supp, pp. 4 and 6-7.

[52] Companies' St. 1-RJ, pp. 1-2.

[53] Companies' St. 1-RJ, pp. 2-3.

Third, and perhaps most importantly, the illustrative calculation Mr. Smith provided actually proved that there is **not** a practical way to implement his recommendation, as Mr. Fullem also explained:

> Exhibit KMS-3 for each of the Companies provided the data that were the inputs for calculating an initial DSIC quarterly charge; this data included the original cost of the DSIC-eligible plant by type of plant. Although Mr. Smith might have tried using this data and his proposed methodology to attempt to calculate an "effective" state tax rate, a revenue conversion factor based on that "effective" tax rate, and the resulting pre-tax rate of return, he chose instead to create a very simplified hypothetical example in which he assumed values that are not derived from, or necessarily related to, any actual data or realistic scenarios for the Companies. In doing so, Mr. Smith *assumed away* the most complicated and difficult part of the process of applying his methodology to a real-world situation. *The fact that an accurate, understandable example showing how to implement Mr. Smith's recommendation based on actual data was not provided supports my position that there is not a practical way to implement Mr. Smith's recommendation, and an attempt to do so would entangle the Commission in the kind of detailed revenue requirement analysis it has previously held is not required for calculating just and reasonable charges under an adjustment clause such as the DSIC.*[54]

Unfortunately, the difficulties in trying to implement the OCA's proposal were minimized in the R.D., which assumed that those difficulties could be worked out "in the compliance filing phase of this proceeding."[55] However, it is not entirely clear how that would be accomplished without conducting another evidentiary proceeding at the "compliance filing phase" to try to come up with a workable solution – assuming there is one. In fact, there is no practical way to translate Mr. Smith's preferred methodology into a workable revision to the DSIC.

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[54] Companies' St. 1-RJ, pp. 4-5 (emphasis added).

[55] R.D., p. 32.

In addition, the R.D. based its recommendation, in large part, on the assumption that the Companies had in some fashion conceded that the OCA's proposed implementation method was "simplistic," notwithstanding the intractable problems with the OCA's methodology that the Companies' witness had described in detail in his testimony, which were also described in the Companies' Supplemental Initial Brief and are summarized above.[56] However, page 18 of the Companies' Supplemental Initial Brief, which the R.D. cites as the basis for its comment in footnote 3, says the exact opposite of what the R.D. attributes to it. In fact, the substance of the argument on page 18 of the Companies' Supplemental Initial Brief consists of the quote from Mr. Fullem's rejoinder testimony, which is reproduced above. As that quotation makes clear, the Companies' criticism is that Mr. Smith started with *hypothetical* numbers to try to apply his methodology. The difficulty with his approach lies in deriving actual, Company-specific depreciation levels, deductions, taxable income and reported income. Mr. Smith ignored that step by starting with "assumed" values. As Mr. Fullem explained, Mr. Smith used a "simplified hypothetical example" and, therefore, he "assumed away the most complicated and difficult part of the process of applying his methodology." Simply stated, the R.D. misunderstood and, therefore, mischaracterized, the Companies' position.

3. Summary – Implementation Issues

The hypothetical calculation of the OCA's "preferred method" provided in Mr. Smith's Supplemental Surrebuttal Testimony cannot be translated into a workable revision to the DSIC formula reflecting property-related state income tax deductions and credits, as the OCA erroneously contends and the R.D. recommends. The fact that Mr. Smith's recommendation cannot, as a practical matter, be implemented is a further reason for rejecting the OCA's

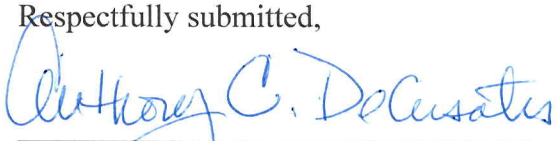
[56] *See* R.D., p. 33, n. 3.

fundamental position on the contested issue. As previously explained, attempting to actually implement the OCA's proposal creates fundamental conflicts with the express statutory language of Sections 1351 and 1357. Sections 1351 and 1357(b)(1) and (2) specify the elements of the DSIC formula – none of which provide for deducting ADIT from the original cost of eligible plant or for adjusting the statutory state tax rate to reflect an "effective" state income tax rate. The Model Tariff, as approved in the Final Implementation Order, which specifies the use of statutory tax rates and expressly rejected deducting ADIT from the original cost of eligible property in calculating the DSIC, is consistent with the terms of Sections 1351 and 1357, and should not be revised in the manner the OCA proposes.

V. CONCLUSION

For all the reasons discussed above and in the Companies' Initial and Reply Briefs and Supplemental Initial and Reply Briefs, the Companies' Exceptions should be granted and ALJ's recommendations regarding the contested issue should be rejected. Consistent with the ALJ's recommendation, the Joint Petition for Settlement of Pending Issues should be approved without modification.

Respectfully submitted,



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